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# SECURITIES OPERATIONS

## Update on Actions Taken to Address Day Trading Concerns



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<b>Abstract</b> In 1999, day trading began to receive intense scrutiny from state and federal regulators and the Congress because of concerns that it posed significant investor protection and market integrity issues. In particular there was concern that broker-dealers promoting day trading as a strategy (day trading firms) sometimes used questionable advertising to attract customers without fully disclosing or by downplaying the risks involved. Many were also concerned that traders were losing large amounts of money by using a day trading strategy.		
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Congressional Requesters

In 1999, day trading<sup>1</sup> began to receive intense scrutiny from state and federal regulators and the Congress because of concerns that it posed significant investor protection and market integrity issues. In particular there was concern that broker-dealers promoting day trading as a strategy (day trading firms) sometimes used questionable advertising to attract customers without fully disclosing or by downplaying the risks involved. Many were also concerned that traders were losing large amounts of money by using a day trading strategy.

This letter responds to your February 5, 2001, request that we review the status of issues addressed in our 2000 report, *Securities Operations: Day Trading Requires Continued Oversight*<sup>2</sup> and concerns raised by the Permanent Subcommittee on Investigations (Permanent Subcommittee), Senate Committee on Governmental Affairs in its report, *Day Trading: Case Studies and Conclusions* (July 27, 2000). Our objectives were to (1) determine how day traders as a group and day trading firms' operations have changed since 1999, (2) identify the actions regulators have taken to address our report recommendations and the Permanent Subcommittee's concerns about day trading, and (3) identify any actions day trading firms have taken in response to concerns raised about day trading.

To fulfill our objectives, we interviewed officials from six of the seven firms we interviewed for our 2000 report, one additional firm, and state and federal regulators to learn how day trading has changed since 1999. We also collected information on actions regulators have taken to address concerns previously raised about day trading. Specifically, we reviewed examination reports completed by the Securities and Exchange Commission (SEC) and NASD Regulation, Inc. (NASDR), the regulatory arm of the National Association of Securities Dealers (NASD),<sup>3</sup> from late

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<sup>1</sup>Day trading generally involves a strategy of making multiple purchases and sales of the same securities throughout the day in an attempt to profit from short-term price movements via direct access to securities markets.

<sup>2</sup>GAO/GGD-00-61, February 24, 2000.

<sup>3</sup>NASD is one of the self-regulatory agencies charged with overseeing the activities of its member broker-dealers.

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1999 to August 2001. We also reviewed various new and amended rules pertaining to day trading. Finally, we reviewed the Web sites of more than 200 firms identified by SEC, NASD, or GAO as providing day trading services to determine what types of information are available there.

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## Results in Brief

Since 1999, day traders as a group and day trading firms have continued to evolve. Financial market regulators and industry officials told us that day traders are generally more experienced and sophisticated about securities markets and investing than they were several years ago. Likewise, day trading firms' operations have evolved, and many have shifted their primary focus away from retail customers and toward attracting institutional customers such as hedge funds and money market managers. In addition, more firms are likely to engage in proprietary trading activities through professional traders that trade the firms' own capital. Finally, although the number of day trading firms appears to have remained constant, several day trading firms have been acquired by other brokerages and market participants whose customers want the direct access to securities markets and market information that technology used by day trading firms provides.

Since our 2000 review, SEC and the self-regulatory organizations (SROs) have taken various actions that address many of the concerns raised about day trading. First, in 2000 SEC approved several SRO rules relevant to day trading. Specifically, NASDR adopted rules requiring broker-dealers that promote a day trading strategy to determine if such a strategy is appropriate for customers and to provide customers with a risk disclosure statement. NASDR and the New York Stock Exchange (NYSE) also amended their margin rules with more restrictive margin requirements for certain day traders. Second, SEC and the SROs have continued to monitor and examine day trading firms and their activities to varying degrees. SEC has continued to conduct "cause" examinations<sup>4</sup> on day trading firms, while NASDR includes examinations of day trading firms in its routine broker-dealer examination cycle. SEC and the SROs also have completed follow-up examinations of some of the firms included in SEC's and NASDR's initial 1999 sweep of day trading firms and have examined all firms that were newly identified as day trading firms in 2000. In addition, SEC and NASDR

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<sup>4</sup>Cause examinations are conducted when the staff has reason to believe there have been violations of the federal securities laws and are occasioned by press reports, complaint letters, or other indications that something is wrong.

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have settled several pending enforcement cases involving day trading firms and their principals.

In addition to the ongoing changes in the industry and regulatory action, day trading firms have responded to changing market conditions and regulatory scrutiny by changing their behavior. The most noticeable changes appear in their advertising and Web site information, which now generally highlight the risks associated with day trading and the fact that day trading is not for everyone. Moreover, industry and regulatory officials said that the decline in the markets, especially among technology company stock prices, appears to have driven many unsophisticated day traders out of the market. Even without these changes in market conditions, the attention that has been focused on day trading and subsequent changes in risk disclosure should help deter many unsophisticated traders with no understanding of the risks involved from being lured into day trading by prospects of easy profits. Day trading firms' Web sites now tend to focus on the benefits of using a day trading firm, such as direct market access, trade execution speed, and low fees and commissions, rather than on unsubstantiated claims of large profits. Moreover, most of the Web sites we reviewed also highlighted the risks of day trading or provided risk disclosures or disclaimers. We also revisited several of the larger day trading firms and found that many of them no longer actively advertise for retail customers but instead rely on personal referrals.

We requested comments on a draft of this report from SEC and NASDR. Both agreed with the report's findings and conclusions. Their comments are reprinted in appendixes I and II. We are making no recommendations in this report.

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## Background

The term "day trading" has various definitions. In 1999, day trading was commonly described as a trading strategy that involved making multiple purchases and sales of the same securities throughout the day in an attempt to profit from short-term price movements. Since that time, the definition has evolved. For example, NASDR and NYSE use two definitions of day trading in the recent amendments to their margin rules. First, NYSE Rule 431(f)(8)(B)(I) and NASDR Rule 2520(f)(8)(b) generally define day trading as "the purchasing and selling or the selling and purchasing of the

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same security in the same day in a margin account.”<sup>5</sup> Second, both NYSE and NASD define a “pattern” day trader as a customer who executes four or more day trades within 5 business days, unless the number of day trades does not exceed 6 percent of their total trading activity for that period. Additionally, NASDR’s rule on approval procedures for day trading accounts defines a day trading strategy as “an overall trading strategy characterized by the regular transmission by a customer of intra-day orders to affect both purchase and sale transactions in the same security or securities.” In this report, we define day trading as consistently both buying and selling the same securities intraday via direct access technology to take advantage of short-term price movements.

Day trading firms use sophisticated order routing and execution systems technology<sup>6</sup> that allows traders to monitor and access the market on a real-time basis. This technology allows traders direct access to stock markets through Nasdaq Level II screens<sup>7</sup> that display real-time best bid (buy) and ask (sell) quotes for any Nasdaq or over-the-counter security, including quotes between market makers<sup>8</sup> trading for their own inventories. Day traders also conduct transactions through electronic communications networks (ECNs), which allow customers’ orders to be displayed to other customers and allow customers’ orders to be paired.<sup>9</sup> As a result of this technology, day traders have the tools to trade from their own accounts without an intermediary such as a stock broker and can employ techniques that were previously available only to market makers and professional traders.

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<sup>5</sup>Both rules define day trading as the purchasing and the selling or the selling and purchasing of the same security on the same day in a margin account. There are two exceptions to this definition: first, a long security position held overnight and sold the next day prior to any new purchase of the same security; and second, a short security position held overnight and purchased the next day prior to any new sale of the same security.

<sup>6</sup>Order routing and execution systems allow traders to direct their trades to specific market makers (see footnote 9) or market centers that subsequently execute the trade.

<sup>7</sup>Subscribers to Nasdaq’s Level II receive displays of all quotes in real time and see the inside market (bid and asked quotes between dealers trading for their own inventories) for any given Nasdaq or over-the-counter bulletin board security and other market data.

<sup>8</sup>A market maker is a dealer that maintains a market in a given security by buying or selling over-the-counter securities at quoted prices.

<sup>9</sup>An ECN is an electronic trading system that automatically matches buy and sell orders at specified prices. ECNs register with the SEC as broker-dealers.

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Day trading firms register with SEC and become members of one of the SROs, such as NASD or the Philadelphia Stock Exchange; they are therefore subject to regulation by SEC and an SRO. As registered broker-dealers, day trading firms are required to comply with all pertinent federal securities laws and SRO rules. SROs generally examine every broker-dealer anywhere from annually to up to every four years, depending on the type of firm. Day trading firms are also subject to the securities laws and oversight of the states in which they are registered.

In 1999, state and federal regulators began to identify concerns about certain day trading firms' activities. In 1999, state regulators examined and initiated disciplinary action against several day trading firms and identified several areas of concern. SEC completed an examination sweep of 47 day trading firms in 1999 and subsequently issued a report.<sup>10</sup> According to SEC's report, the examinations did not reveal widespread fraud, but examiners found indications of serious violations of securities laws related to net capital, margin, and customer lending. However, most of the examinations revealed less serious violations and concluded that many firms needed to take steps to improve their compliance with net capital, short sale, and supervision rules. NASDR also initiated a series of focused examinations of day-trading firms that focused on the firms' advertising and risk disclosures, among other areas. SEC and NASDR also initiated several enforcement actions against day trading firms and individuals in early 2000.

In our 2000 report, we found that day trading among less-experienced traders was an evolving segment of the securities industry. Day traders represented less than one-tenth of 1 percent, or about 1 out of 1,000, of all individuals who bought or sold securities. However, day trading was estimated by some to account for about 15 percent of Nasdaq's trading volume. Although no firm estimates exist for the number of active day traders, many regulatory and industry officials we spoke with generally thought 5,000 was a reasonable estimate and believed the number was stable or had gone down slightly. However, the number of open accounts at day trading firms is likely much higher.<sup>11</sup>

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<sup>10</sup>*Report of Examination of Day Trading Broker-Dealers* (Feb. 25, 2000).

<sup>11</sup>The Permanent Subcommittee determined the number of day trading accounts to be over 13,000 in 1999.

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We also noted in our 2000 report that before 1997, day traders submitted most of their orders through the Small Order Execution System (SOES).<sup>12</sup> We concluded that the effects of day trading in an environment that depends less on SOES and more on ECNs are uncertain. Because of these findings and our work in this area, we recommended that after decimal trading is implemented, SEC should evaluate the implications of day traders' growing use of ECNs on the integrity of the markets. We also recommended that SEC do an additional cycle of targeted examinations of day trading firms to ensure that the firms take the necessary corrective actions proposed in response to previous examination findings.

Concerns about day trading culminated in hearings before the Permanent Subcommittee on February 24 and 25, 2000,<sup>13</sup> and the ultimate issuance of a report by the Permanent Subcommittee in July 2000.<sup>14</sup> The Permanent Subcommittee expressed its concerns about certain industry practices at the hearing and made several recommendations in its subsequent report. In general, the recommendations suggested changes to NASDR's disclosure rules and margin rule amendments and summarized comments Permanent Subcommittee Members had submitted to SEC when those rules were published for comment in the *Federal Register*. In addition, the Permanent Subcommittee recommended that NASDR prohibit firms from arranging loans between customers to meet margin requirements and that firms be required to develop policies to ensure that individual day traders acting as investment advisors are properly registered.

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## Day Trading Firms Have Continued to Evolve

Since 1999, day traders as a group and firms that offer day trading capability have continued to evolve. Most regulators and industry officials we spoke with said that day traders are generally more experienced and that fewer customers are quitting their jobs to become day traders. We also found that many day trading firms now market to institutional customers,

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<sup>12</sup>SOES is an execution system that allows small orders placed through it to be automatically executed against Nasdaq market makers at the best bid (buy) or ask (sell) prices displayed on the Nasdaq system. It allows customers to access and trade with market makers without having to call them on the phone.

<sup>13</sup>*Day Trading: Everyone Gambles but the House*, Hearings before the Permanent Subcommittee on Investigations of the Committee on Governmental Affairs, U.S. Senate, Feb. 24 and 25, 2000.

<sup>14</sup>*Day Trading: Case Studies and Conclusions*, Report by the Permanent Subcommittee on Investigations (July 27, 2000).

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such as hedge funds<sup>15</sup> and money market managers, rather than focusing on retail customers. In addition, more day trading firms are likely to engage in proprietary trading through professional traders who trade the firms' capital rather than their own and earn a percent of the profits. Finally, we found that traditional and on-line brokers and other entities that want to offer their customers direct access to securities markets are acquiring day trading firms.

A concern raised in 1999 was that day trading firms were marketing to inexperienced traders who did not fully understand the risks of day trading and therefore lost substantial amounts of money. Some industry and regulatory officials said the combination of intense regulatory scrutiny and adverse market conditions in late 2000 and into 2001 have driven many unsophisticated traders out of day trading. Traders currently engaged in day trading are more likely to be experienced and to have a greater knowledge of the risks involved than traders in 1999. Industry officials said that many traders gained their experience by day trading for several years, while others were professional traders who became day traders.

During our first review, regulatory and government officials were particularly concerned that day trading firms were attracting customers who were ill-suited for day trading because they lacked either the capital or the knowledge to engage in such a risky activity. Since 1999, day trading firms have begun to focus on institutional as well as retail customers, including hedge funds and small investment management companies. According to press reports, All-Tech Direct, Inc., a day trading firm, announced in August 2001 that it planned to get out of the retail business completely and was severing its relationship with all of its retail branches. Overall, institutional investors are increasingly interested in the kind of high-speed order execution that day traders get from direct access systems and the relatively low fees day traders pay to execute trades.

In addition, some day trading firms that focused solely on retail customers in 1999 have since hired professional traders who trade the firms' capital (proprietary traders). For some, this move reflects a departure from their retail customer focus. A few officials said many of their retail customers

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<sup>15</sup>Although there is no statutory definition of a hedge fund, it is generally a private and unregistered investment vehicle that often engages in active trading of investment pools in various types of securities and commodities. Hedge funds are largely unregulated.

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started as proprietary traders and learned to trade by using the firm's capital rather than their own.

Another change involves the growth in the number of day trading firms being acquired by other brokerages and in market participants that want the direct access technology. For example, since 1999 on-line brokers Charles Schwab and Ameritrade have purchased CyberCorp. (former CyberTrader) and Tradecast, respectively. Likewise, in August 2001 T.D. Waterhouse Group Inc. announced plans to purchase one of the smaller day trading firms, R.J. Thompson Holdings. In addition, Instinet, an ECN, purchased ProTrader as a way to offer direct access technology to its customers.<sup>16</sup> Moreover, financial conglomerates are also moving toward offering fully integrated services, which include all aspects of a securities purchase, from direct access to securities markets to clearing capabilities. In September 2000, Goldman Sachs announced its planned acquisition of Spear Leeds & Kellogg, which offers such fully integrated services. Other firms with fully integrated capabilities include on-line brokerages such as Ameritrade and Datek, as well as an ECN, Instinet.

Some regulatory and industry officials said that they expect traditional and discount brokerages to continue to acquire day trading firms, as these brokerages face increased pressure to provide direct market access to their more active traders (estimated at between 50,000 and 75,000). Some analysts also said that the growing trend toward direct access has been driven not only by competitive pressure but also by SEC's new disclosure rules on order handling and trade execution, which require ECNs, market makers, and specialists to report execution data on order sizes, speed, and unfilled orders. In addition, by the end of November 2001 brokers are required to disclose the identity of the market centers to which they route a significant percentage of their orders and the nature of the broker's relationships with these market centers, including any payment for order flow.<sup>17</sup> By offering customers direct access to markets, the customer rather than the broker determines where trades are executed.

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<sup>16</sup>According to an industry official, Instinet required ProTrader to shed its proprietary trading business to focus on the agency opportunities—both retail and institutional.

<sup>17</sup>Payment for order flow is a method of transferring some of the trading profits from market making to the brokers that route customer orders to specialists for execution (firms usually pay a penny or more per share in return for the order flow).

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## Regulators Have Taken Actions to Address Some Concerns About Day Trading Firms

Since our 2000 review, SEC and the SROs have taken various actions involving day trading activities. Specifically, NASDR has adopted rules that require firms to provide customers with a risk disclosure statement and to approve the customer's account for day trading. In addition, NASDR and NYSE have amended their margin rules for day traders to impose more restrictive requirements for pattern day traders. NASDR's margin rule amendments became effective on September 28, 2001, and NYSE's became effective on August 27, 2001. SEC and the SROs have also continued to monitor and examine day trading firms and their activities to ensure compliance with securities laws. Finally, SEC and NASDR have settled several pending enforcement cases involving day trading securities firms and their principals.

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## SROs Have Finalized Disclosure Rules That Promote Improved Risk Disclosure

In 2000 and 2001, the SROs adopted day trading rules related to improved risk disclosure and stricter margin requirements. On July 10, 2000, SEC approved NASDR Rule 2360, Approval Procedures for Day-Trading Accounts, which requires firms that promote a day trading strategy<sup>18</sup> to either 1) approve the customer's account for a day trading strategy or 2) obtain from the customer a written agreement that the customer does not intend to use the account for day trading purposes. SEC also approved NASDR Rule 2361, Day-Trading Risk Disclosure Statement, which requires firms that promote a day trading strategy to furnish a risk-disclosure statement that discusses the unique risks of day trading to customers prior to opening an account.<sup>19</sup> The new rules became effective on October 16, 2000.

NASDR Rule 2361 provides a disclosure statement that, among other things, warns investors that day trading can be risky and is generally not appropriate for someone with limited resources, little investment or trading experience, or tolerance for risk (see table 1). The statement

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<sup>18</sup>NASDR Rule 2360 defines a day trading strategy to mean a trading strategy characterized by the regular transmission by a customer of intraday orders to effect both purchase and sale transactions in the same security.

<sup>19</sup>In lieu of the disclosure statement contained in Rule 2361, a NASD member may provide an alternative disclosure statement that is substantially similar to the one provided by NASDR as long as the alternative disclosure statement is filed with NASDR's Advertising Department for review and approval 10 days prior to using the statement.

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further maintains that evidence suggests that an investment of less than \$50,000 significantly affects the ability of a day trader to make a profit.

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**Table 1: Final Rule 2361, Day Trading Risk Disclosure Statement**

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**Day Trading Risk Disclosure Statement as Adopted by NASDR**

**Day trading can be extremely risky.** Day trading generally is not appropriate for someone of limited resources and limited investment or trading experience and low risk tolerance. You should be prepared to lose all of the funds that you use for day trading. In particular, you should not fund day-trading activities with retirement savings, student loans, second mortgages, emergency funds, funds set aside for purposes such as education or home ownership, or funds required to meet your living expenses. *Further, certain evidence indicates that an investment of less than \$50,000 will significantly impair the ability of a day trader to make a profit. Of course, an investment of \$50,000 or more will in no way guarantee success.*

**Be cautious of claims of large profits from day trading.** You should be wary of advertisements or other statements that emphasize the potential for large profits in day trading. Day trading can also lead to large and immediate financial losses.

**Day trading requires knowledge of securities markets.** Day trading requires in-depth knowledge of the securities markets and trading techniques and strategies. In attempting to profit through day trading, you must compete with professional, licensed traders employed by securities firms. You should have appropriate experience before engaging in day trading.

**Day trading requires knowledge of a firm's operations.** You should be familiar with a securities firm's business practices, including the operation of the firm's order execution systems and procedures. Under certain market conditions, you may find it difficult or impossible to liquidate a position quickly at a reasonable price. This can occur, for example, when the market for a stock suddenly drops, or if trading is halted due to recent news events or unusual trading activity. The more volatile a stock is, the greater the likelihood that problems may be encountered in executing a transaction. In addition to normal market risks, you may experience losses due to system failures.

**Day trading will generate substantial commissions, even if the per trade cost is low.** Day trading involves aggressive trading, and generally you will pay commissions on each trade. The total daily commissions that you pay on your trades will add to your losses or significantly reduce your earnings. *For instance, assuming that a trade costs \$16 and an average of 29 transactions are conducted per day, an investor would need to generate an annual profit of \$111,360 just to cover commission expenses.*

**Day trading on margin or short selling may result in losses beyond your initial investment.** When you day trade with funds borrowed from a firm or someone else, you can lose more than the funds you originally placed at risk. A decline in the value of the securities that are purchased may require you to provide additional funds to the firm to avoid the forced sale of those securities or other securities in your account. Short selling as part of your day-trading strategy also may lead to extraordinary losses, because you may have to purchase a stock at a very high price in order to cover a short position.

**Potential Registration Requirements.** Persons providing investment advice for others or managing securities accounts for others may need to register as either an "Investment Advisor" under the Investment Advisors Act of 1940 or as a "Broker" or "Dealer" under the Securities Exchange Act of 1934. Such activities may also trigger state registration requirements.

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Note: *Italicized* text generally represents changes that respond to issues raised by the Permanent Subcommittee.

Source: NASDR Notice to Members 00-62, September 2000.

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The disclosure statement contained in NASDR Rule 2361 incorporated many of the recommendations the Permanent Subcommittee Members made in a comment letter to SEC and subsequently summarized in its July 27, 2000, report.<sup>20</sup> The italicized text in table 1 generally represents the Permanent Subcommittee's recommended changes that NASDR adopted. Although many of the Permanent Subcommittee's recommendations were incorporated into the final disclosure statement, NASDR did not adopt all of them. For example, NASDR did not directly adopt the Permanent Subcommittee's recommendations that firms presume that customers who open accounts with less than \$50,000 are generally inappropriate for day trading<sup>21</sup> or that firms be required to prepare and maintain records setting forth the reasons why customers with less than \$50,000 are considered appropriate for day trading. Instead, NASDR incorporated the Permanent Committee's concern about the significance of the \$50,000 threshold into the disclosure statement. NASDR decided not to directly incorporate these recommendations for several reasons. First, it believed that a \$50,000 threshold might make sense for some investors but could be too high or too low for others. Second, NASDR was concerned that such a requirement could encourage investors to inflate the value of their assets. Lastly, NASDR's rule (as proposed) already required a firm to document the basis on which it approved an account for day trading.

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## NASDR and NYSE Amended Their Margin Requirements to Include More Restrictive Requirements for Day Traders

In February 2001, SEC approved substantially similar amendments to NASDR and NYSE rules proposing more restrictive margin requirements for day traders. Prior to the adoption of the NASDR and NYSE amendments, margin requirements were calculated on the basis of a customer's open positions at the end of the trading day.<sup>22</sup> A day trader often has no open positions at the end of the day on which a margin calculation can be based. However, the day trader and the firm are at financial risk throughout the day if credit is extended. To address that risk, the NASDR and NYSE rule amendments require "pattern day traders" to demonstrate

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<sup>20</sup>During the period that the proposed rule was published in the *Federal Register* for comment, Permanent Subcommittee Members submitted a comment letter with suggested modifications to the rule and summarized those comments in the July 2000 report.

<sup>21</sup>However, the firm could overcome this presumption with other factors it believed would outweigh the inadequate risk capital.

<sup>22</sup>NASDR Rule 2520 and NYSE Rule 431 are the margin provisions for the NASD and NYSE, respectively.

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that they have the ability to meet a special maintenance margin requirement for at least their largest open position during the day.<sup>23</sup> Customers who meet the definition of pattern day trader under the rules must generally deposit 25 percent of the largest open position into their accounts.

Both rule amendments require customers who meet the definition of a pattern day trader to have minimum equity of \$25,000 in their accounts. Funds deposited into these accounts to meet the minimum equity requirement must remain there for a minimum of 2 business days following the close of business on the day a deposit was required.

In addition, the rule amendments permit day trading buying power of up to four times excess margin<sup>24</sup> and impose a day trading margin call on customers who exceed their day trading buying power. In addition, until the margin call is met, day trading accounts are restricted to day trading buying power of two times excess margin, calculated on the basis of the cost of all day trades made during the day. If the margin call is not met by the 5th business business day, day traders are limited to trading on a cash-available basis for 90 days or until the call is met. Funds deposited in an account to meet a day trading margin call must also remain in the account for 2 business days. The rule amendments also prohibit cross-guarantees<sup>25</sup> to meet day trading minimum equity requirements or day trading margin calls.

These more stringent margin requirements respond to concerns raised about the risks day trading can pose to traders, firms, and securities markets in general. The amendments as finalized do not fully incorporate the Permanent Subcommittee's recommendation that the minimum equity requirement be raised from \$2,000 to \$50,000. Instead, SEC approved a \$25,000 minimum. NASDR believes that a \$25,000 minimum equity requirement will provide "protection against continued losses in day trading accounts, while refraining from excessive restrictions on day

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<sup>23</sup>The NASDR Rule further requires a firm that knows or has reason to believe that a customer is a pattern day trader to designate the customer as such immediately.

<sup>24</sup>Excess margin is the amount of equity in a customer's margin account in excess of the required maintenance margin requirement.

<sup>25</sup>Cross-guarantees consolidate accounts and permit maintenance margin based on the net positions of both accounts.

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traders with limited capital.” Moreover, both NASDR and NYSE said that broker-dealers have the option of increasing the minimum requirement based on their own policies and procedures.

The Permanent Subcommittee also recommended that the margin ratio not be increased to four times excess equity from its previous level of two times. NASDR and NYSE disagreed with this proposed change, because allowing day traders to trade at a 4:1 ratio brings day trading accounts into parity with ordinary NASDR and NYSE maintenance margin account requirements, which are 25 percent, or 4:1. Moreover, officials said the change was appropriate when considered in conjunction with the other changes to the margin rules, such as the increased minimum equity requirement, the immediate consequences imposed if day trading buying power is exceeded, and the 2-day holding period for funds used to meet day trading margin requirements.

The Permanent Subcommittee also recommended that NASDR propose a rule prohibiting firms from arranging loans between customers to meet margin calls. NASDR is continuing to review this issue but has not proposed rules that directly address firms’ involvement in arranging such loans. However, industry officials believe that the new margin rules indirectly address this issue because the amendments will make such lending arrangements less attractive to lenders. For example, as mentioned previously, funds deposited to meet a margin call must be left in a trader’s account for two full business days following the close of business on any day when a deposit is required, substantially increasing the risks to the lender. Previously, funds could be held in an account overnight to meet the margin call requirement.

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## SEC and the SROs Continue to Find Violations at Day Trading Firms

Consistent with our 2000 report recommendation, SEC has continued to examine the activities of day trading firms. Specifically, since SEC’s initial sweep of 47 day trading firms from October 1998 to September 1999 and subsequent report,<sup>26</sup> SEC, NASDR, and Philadelphia Stock Exchange staff have conducted examinations of all the 133 day trading firms that were identified in 2000. In addition, SEC and the SROs have done follow-up examinations to determine whether the previous violations have been

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<sup>26</sup>*Special Study: Report of Examinations of Day-Trading Broker-Dealers* (Feb. 25, 2000).

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corrected.<sup>27</sup> Moreover, NASDR officials said they prepared a special examination module for these follow-up examinations that focused on identified problem areas. According to SEC, in 2001 and 2002, SRO staff will continue to conduct routine examinations of existing day trading firms and of newly registered firms to determine compliance with applicable rules. For example, NASDR officials said that they are no longer prioritizing day trading firms for review; instead, these firms are now examined during the routine broker-dealer examination cycle or when they first register. As of August 2001, NASDR had completed about 62 such examinations. In addition, SEC said that it would continue to initiate cause examinations when appropriate. From late 1999 to early 2001, almost half of the day trading firm examinations completed by SEC were cause examinations.

According to SEC and NASDR officials, day trading firms' overall compliance with rules has improved since the 1999 sweep. Officials said that while the examinations revealed violations of margin rules, short sale rule violations, misleading advertisements, and net capital deficiencies, these types of violations were occurring less frequently. SEC also identified violations of SRO and SEC rules related to supervision, maintenance of books and records, and the net capital calculation. SEC and NASDR officials said that net capital and supervision violations are not uncommon among broker-dealers in general.

We reviewed 42 SEC and 62 NASDR examination reports completed between the end of the 1999 sweep and August 2001 that looked at broker-dealers and their branches offering day trading as a strategy. Overall, written supervisory procedure failures<sup>28</sup> were the most frequent violation,

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<sup>27</sup>SEC's *Report in Response to Congressmen Dingell, Markey, and Towns' Letter of February 5, 2001 Regarding Efforts to Address Questionable Practices at Day-Trading Firms* (June 22, 2001).

<sup>28</sup>NASDR rules require each broker-dealer to establish, maintain, and enforce written procedures that enable it to supervise its registered representatives and associated persons and to ensure that the member complies with applicable securities laws.

followed by net capital rule<sup>29</sup> miscalculations. Table 2 shows the number of examinations that included violations in each area.<sup>30</sup> However, many of the violations cited in the examination reports were violations that are often cited at all types of broker-dealers and were not directly related to the firm's day trading activity, which in some cases was a small part of the firm's overall operation. Common supervisory procedure violations involved failure to have adequate written procedures that reflect the types of business in which the firm engages. For example, some broker-dealers had added day trading to their offered services but had not changed their written supervisory procedures to address this new activity. Other firms were cited for failure to follow their internal supervisory procedures. Many of the net capital rule violations involved calculation and reporting errors.

**Table 2: SEC and NASDR Examinations With Various Violations**

<b>Violations</b>	<b>Number of SEC examinations with violations</b>	<b>Number of NASDR examinations with violations</b>
Written Supervisory Procedures	25	36
Net Capital	21	25
Short Sale Rules	7	10
Advertising	11	5
Customer Lending and Margin Rules	8	1
Other	31	50
<b>Total Examinations reviewed</b>	<b>42</b>	<b>62</b>

Note: Columns do not add up to the total number of firms examined, because many examinations had multiple violations and others had none.

Sources: SEC and NASDR broker-dealer and branch examination reports.

<sup>29</sup>The net capital rule is a liquidity standard that requires broker-dealers to (1) maintain a minimum level of liquid capital sufficient to promptly satisfy all of its obligations to customers and other market participants and (2) provide a cushion of liquid assets to cover potential market, credit, and other risks.

<sup>30</sup>Some firms were examined more than once during the period reviewed.

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Compared with the written supervisory procedure and net capital rule violations, fewer examinations had short sale,<sup>31</sup> advertising, and margin and customer-lending rule<sup>32</sup> violations. The short sale rule violations included failing to properly indicate trades as “short” (sale) or “long” (purchase), effecting short sales below the price at which the last sale was reported or on a zero-minus tick,<sup>33</sup> and improperly marking short orders as long without first making an affirmative determination that the securities were in the trader’s account or ready to be delivered prior to settlement. Although examiners continued to find some advertising violations involving omissions of fact and misstatements, many of the violations involved failure to properly maintain advertising files and other documentation requirements. For example, firms were cited for failure to document advertising approvals and make required submissions to NASDR. The customer lending and margin violations involved failure to secure additional funds to cover margin calls and allowing traders to trade when the Regulation T<sup>34</sup> margin requirement had not been met. Numerous other deficiencies were also cited, including failure to inform customers who access SelectNet<sup>35</sup> that NASD monitors trading activity and that the customers can be subject to prosecution for violations of securities laws, improper registration issues such as failure to properly register branches, and improper registration of traders.

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<sup>31</sup>A short sale refers to any sale of a security that the seller does not own or any sale that is consummated by the delivery of a security borrowed by, or for the account of, the seller.

<sup>32</sup>Customers that trade in margin accounts are subject to the initial margin and maintenance margin requirements, among other requirements. Similarly, customers may lend other customers money to meet margin requirements, but broker-dealers and associated persons are restricted in their ability to lend to customers.

<sup>33</sup>A zero-minus tick refers to selling at the same price as the preceding price that is less than the most immediate different preceding price.

<sup>34</sup>Regulation T is a Federal Reserve rule that specifies initial margin requirements. For example, it requires an initial margin of 50 percent for new purchases of equities in margin accounts.

<sup>35</sup>SelectNet is an electronic, screen-based order routing system that allows market makers and participants to negotiate securities transactions in Nasdaq securities through computer communications rather than over the telephone.

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Of the SEC examinations reviewed, 34 resulted in deficiency or violation letters,<sup>36</sup> 3 indicated that no violations had been found, and 7 resulted in a referral to an SRO or to SEC's Division of Enforcement. Of the NASDR examinations we reviewed, 39 resulted in a letter of caution,<sup>37</sup> 5 resulted in a compliance conference,<sup>38</sup> 12 were filed without action, and at least 2 resulted in formal complaints or referrals to SEC or NASDR Enforcement.

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### SEC and NASD Have Settled Disciplinary Actions Against Day Trading Firms and Principals

Since the enforcement actions announced in February 2000, NASDR and SEC have settled several disciplinary actions against day trading firms and their principals, including fines, civil money penalties, censures, and the expulsion of one firm from the business. SEC brought several enforcement actions related to day trading in June 2001. First, SEC instituted and settled proceedings against JPR Capital Corporation and several of the firm's current and former executives. SEC found that the firm had violated federal margin lending rules, among other things. All of the respondents to the proceedings consented to SEC's order without admitting or denying the allegations, agreed to pay civil money penalties, and consented to other relief. The firm was censured and ordered to pay a civil penalty of \$55,000 to "cease and desist" from committing or causing any violations of specified laws and rules and to comply with initiatives designed to improve its own compliance department. Second, SEC settled its previously instituted proceeding against All-Tech Direct, Inc. and certain of its employees for extending loans to customers in excess of limits allowed under federal margin rules. SEC censured All-Tech Direct and ordered the firm to cease and desist from committing or causing any violations of the federal margin lending rules, to pay a \$225,000 civil penalty, and to retain an independent consultant selected by SEC to review and recommend improvements to All-Tech Direct's margin lending practices.

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<sup>36</sup>When examiners find compliance failures or internal control weaknesses, SEC usually provides the broker-dealer with a letter identifying the problems and requires the broker-dealer to take remedial steps. Deficiency letters generally require a written response.

<sup>37</sup>A letter of caution is sent to the firm following an examination citing all violations found during the examination and generally requiring a response from the firm that describes the firms' plans to correct and prevent future violations.

<sup>38</sup>A compliance conference is a meeting NASDR examiners hold with firm management to address violations and the firm's plan to correct the violations and ensure future compliance.

As shown in table 3, NASDR also announced enforcement actions in June 2001 against six firms and several individuals that addressed violations of federal securities laws and NASDR rule violations in the following areas: advertising, registration, improper loans to customers, improper sharing of commissions, short sale rules, trade reporting, and deficient supervisory procedures. Without admitting or denying the allegations, the firms and individuals agreed to the sanctions, which included censures, the expulsion of one firm, suspensions, and fines against the firms and individuals ranging from \$5,000 to \$250,000.

**Table 3: Summary of Violations of Federal Securities Laws and NASDR Rules Resulting in Disciplinary Actions (June 2001)**

<b>Firm and others</b>	<b>Advertising</b>	<b>Registration</b>	<b>Loans to customers</b>	<b>Sharing of commissions</b>	<b>Short sale</b>	<b>Trade reporting</b>	<b>Supervisory procedures</b>	<b>Other</b>
Landmark Securities Corporation and Individual	X	X	X	X	X	X		
Momentum Securities, LLC	X				X	X	X	X
CyBerBroker, Inc. and Individual			X					
Cornerstone Securities Corporation (now ProTrader) and Individual	X			X		X	X	X
Summit Trading	X					X	X	X
All-Tech Direct, Inc. and Individual	X	X						X

Sources: *NASD Regulation Settles Five Disciplinary Actions Involving Day-Trading* (June 7, 2001) and *NASDR Regulation Fines All-Tech, Houtkin, and Other Execs \$380,000 for Day Trading and Advertising Violations; Suspends Individuals* (June 13, 2001).

According to NASDR officials, these settlements resulted from violations that occurred in prior years. While any violation is a serious issue, regulatory officials said that many of these issues have been addressed and that compliance among day trading firms is generally improving. For example, NASDR officials said that they are seeing far fewer misleading advertisements than in 1999.

In August 2001, All-Tech Direct also lost an arbitration proceeding involving allegations of misleading advertising. Four traders filed arbitration proceedings against All-Tech Direct for losses incurred in their day trading accounts. Although firm officials said that the traders lost money when they held open positions overnight—a practice day trading firms usually do

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not recommend—the arbitration panel ruled in favor of the plaintiffs and awarded them a total of over \$456,000. All-Tech Direct officials said they plan to appeal the ruling. As mentioned previously, All-Tech Direct has announced plans to sever its relationship with all of its retail branches. In October 2001, All-Tech Direct filed the necessary paperwork to withdraw its registration as a broker-dealer.

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## Day Trading Firms Have Also Taken Steps to Address Concerns About Day Trading

In addition to the ongoing changes in day trading and in regulatory oversight of the activity, many day trading firms have responded to changing market conditions and regulatory scrutiny. According to some industry and regulatory officials, day trading firms are generally viewed as more knowledgeable and sophisticated in terms of regulatory compliance and management than they were in 1999. We found that most Web sites of day trading firms prominently highlighted the risks associated with day trading or provided easy-to-access risk disclosures or disclaimers. In addition, the sites focused on the speed of trade executions and lower fees rather than on profits. We interviewed officials from seven day trading firms and found that many of these firms no longer actively advertise for retail customers, relying instead on personal referrals. However, other day trading firms continue to advertise, and many allow customers to open an account online via their Web site.

Day trading firms have adjusted the way they operate in response to changing market conditions and regulatory scrutiny. Firm management is generally viewed as more seasoned and sophisticated than it was in 1999. Industry officials said that in general most firms have matured and provide more vigorous oversight than in the past. In addition to the downturn in the securities markets, particularly in the technology sector, day traders and the firms in which they trade have had to adjust to certain market changes. The first of these was decimalization, which resulted in smaller spreads between bid and ask prices. Some industry officials said that the change has made it more difficult for day traders to make profits. As a result, these officials said that they have advised their traders to trade less frequently and in smaller lot sizes. The second change, the movement

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to SuperSoes<sup>39</sup> and ultimately SuperMontage,<sup>40</sup> is also expected to result in changes to how day traders operate. However, SuperMontage is not expected to be fully implemented until 2002. Given these ongoing changes in markets, SEC has not evaluated the growing use of ECNs by day traders on the integrity of the markets.

Regulators and industry officials also said that firms now have more sophisticated monitoring systems, an area of concern identified by regulators in 1999. The firms we visited all had systems that allowed them to monitor the activity of each of their traders (retail and proprietary). In addition, many had set preestablished loss limits for traders. For example, one firm halted trading for customers who lost 30 percent of their equity in a single day. Further, some had systems that allowed them to prevent short sale violations by keeping traders from shorting ineligible stocks. These firms also had compliance departments that were responsible for monitoring the activities of the traders, and some provided regular reports to traders that detailed each trader's daily activity and positions.

Consistent with the findings of SEC and the SROs, we found that the Web sites of firms identified as offering day trading services provided prominent, easy-to-find risk disclosures or disclaimers about day trading. Specifically, 122 of 133 or about 92 percent of the Web sites we were able to access between July and November 2000 had risk disclosures or disclaimers.<sup>41</sup> Many of the firms (and branches) used the NASDR risk disclosure statement or some similar variation. In addition, some provided links to SEC and NASDR Web sites for additional information about the risks of day trading. Rather than claims of easy profitability, many of the sites now focus on trade execution speed and low fees and commissions. Of the 125 firms accepting customers, some 57 firms and their branches allowed customers to file applications online, while 67 required that

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<sup>39</sup>SuperSoes (Super Small Order Execution System) is the revised automatic order execution system for Nasdaq.

<sup>40</sup>SuperMontage will be Nasdaq's new order display window. It will integrate SuperSoes and SelectNet into a single "pipeline" for routing of orders and executions.

<sup>41</sup>We were not able to find obvious risk disclosures or disclaimers for the remaining 11 Web sites (8 percent). However, because we were not able to access all parts of every Web site, our inability to find disclosures or disclaimers may not indicate that they were not provided.

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account applications be faxed or mailed.<sup>42</sup> Some 40 offered training opportunities or links to other providers, and 20 had employment opportunities for traders.

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## Conclusions

Since 1999, day trading has continued to evolve. In general, today's day traders appear to be more experienced and knowledgeable about securities markets than many day traders in the late 1990s. Likewise, many day trading firms have begun to focus on institutional traders as well as retail customers, and more firms are likely to engage in proprietary trading. Finally, other market participants are seeking the direct access technology offered by day trading firms in order to be able to offer fully integrated services.

Regulators have taken various actions in response to concerns raised about day trading. Implementation of disclosure rules and amendments to margin rules have directly or indirectly addressed many of the concerns raised by the Permanent Subcommittee. Moreover, SEC and the SROs have continued to scrutinize the activities of day trading firms since our 2000 report. We recommended that SEC conduct another sweep of day trading firms, given their growing portion of Nasdaq trading volume and the fact that day trading is an evolving part of the industry. SEC addressed this recommendation through follow-up examinations of the firms included in the previous day trading sweep and ongoing examinations of day trading firms. The SROs have performed and plan to continue to perform routine examinations of broker-dealers offering day trading as a strategy. Moreover, SEC plans to continue to conduct cause examinations as needed to maintain a certain degree of scrutiny of these firms' activities. Given the recent move to decimals and ongoing changes in the securities markets, SEC has not yet formally evaluated day trading's effect on markets but officials generally believe that many of the initial problems surrounding these firms have been addressed.

Finally, the firms themselves have adjusted their behavior in response to market changes and regulatory scrutiny. The most noticeable changes appear in their advertising and Web site information, which in many cases now generally highlight the risks associated with day trading and the fact that day trading is not for everyone. Changes in market conditions appear

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<sup>42</sup>We were unable to access the "account opening" screen of the remaining firm and therefore, we could not determine its account opening process.

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to have driven many unsophisticated traders out of day trading, and increased disclosure about risks and continued regulatory oversight should help deter such traders from being lured into day trading by prospects of easy profits when market conditions improve.

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## Agency Comments and Our Evaluation

We requested comments on a draft of this report from the Chairman, SEC, and the President, NASDR. The Director, Office of Compliance Inspections and Examinations, SEC, and the President, NASDR, responded in writing and agreed with the report's findings and conclusions. We also received technical comments and suggestions from SEC and NASDR that have been incorporated where appropriate.

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## Scope and Methodology

To determine how day traders and day trading firms' operations have changed since 1999, we collected data from day trading firms, SEC, NASDR, and other relevant parties. To determine what types of changes have occurred in day trading, we reviewed available research on the subject and interviewed state and federal regulators, as well as several knowledgeable industry officials from seven of the larger day trading firms (including six of the seven we had interviewed previously). We compared these responses with the information we obtained in our 2000 report. Specifically, we obtained insights from regulatory and industry officials on overall changes in day trading and in the number of day traders. We discussed changes in the markets, such as decimalization, and how the move to decimals has impacted day traders. We also discussed common trends among day traders and day trading firms. In addition, we collected information on changes specific to individual firm operations. Finally, we also discussed the concerns raised and recommendations made by the Permanent Subcommittee and GAO in the respective 2000 reports.

To identify the actions regulators have taken to address the Permanent Subcommittee's concerns about day trading and our report recommendations, we met with officials from SEC and NASDR to discuss their actions involving day trading oversight. We also reviewed 104 examination reports that had been completed since 1999. We determined the frequency of the violations and the actions taken by SEC and NASDR in response to those violations. We spoke with a state regulatory official from Massachusetts and an official of the North American Securities Administrators Association about day trading and state regulatory oversight activities. Finally, we reviewed newly implemented or amended

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rules affecting day trading to determine whether they addressed the Permanent Subcommittee's recommendations.

To identify any actions taken by day trading firms in response to concerns raised about day trading, we interviewed officials from six of the seven day trading firms we identified in our 2000 report and from one additional firm about the initiatives the firms were taking pertaining to issues raised by the regulators and Congress.<sup>43</sup> These issues included advertising, risk disclosure, margin issues, and determinations of appropriateness. We also discussed how the firms' operations had changed over the previous 2 years. In addition, we reviewed the Web sites of over 200 firms that we identified as day trading firms (some were actually branches of other firms). We reviewed the sites and obtained information on the account opening process, training offers, proprietary trading opportunities, and risk disclosures, among other things.

We conducted our work in Jersey City and Montvale, NJ; New York, NY; Austin and Houston, TX; and Washington, D.C., between April and November 2001 in accordance with generally accepted government auditing standards.

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As agreed with your offices, unless you publicly release its contents earlier, we plan no further distribution of this report until 30 days from its issuance date. At that time, we will send copies of this report to the Chairman and Ranking Minority Member of the Senate Committee on Banking, Housing and Urban Affairs; the Chairmen and Ranking Minority Members of the Senate Committee on Governmental Affairs and Permanent Subcommittee on Investigations; Chairmen of the House Committee on Financial Services and its Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises; Chairmen of the House Energy and Commerce Committee and its Subcommittees on Commerce, Trade and Consumer Protection and on Telecommunications and the Internet; and other congressional committees. We will also send copies to the Chairman of SEC, the Presidents of NASDR and NYSE. Copies will also be made available to others upon request.

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<sup>43</sup>The seventh firm had not solicited for new customers in over 5 years.

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If you or your staff have any questions regarding this report, please contact Orice M. Williams or me at (202) 512-8678. Key contributors to this report were Toayoa Aldridge, Robert F. Pollard, and Sindy Udell.

A handwritten signature in black ink, appearing to read "Richard J. Hillman".

Richard J. Hillman  
Director, Financial Markets  
and Community Investment

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### List of Requesters

The Honorable John D. Dingell  
Ranking Minority Member  
Committee on Energy and Commerce  
House of Representatives

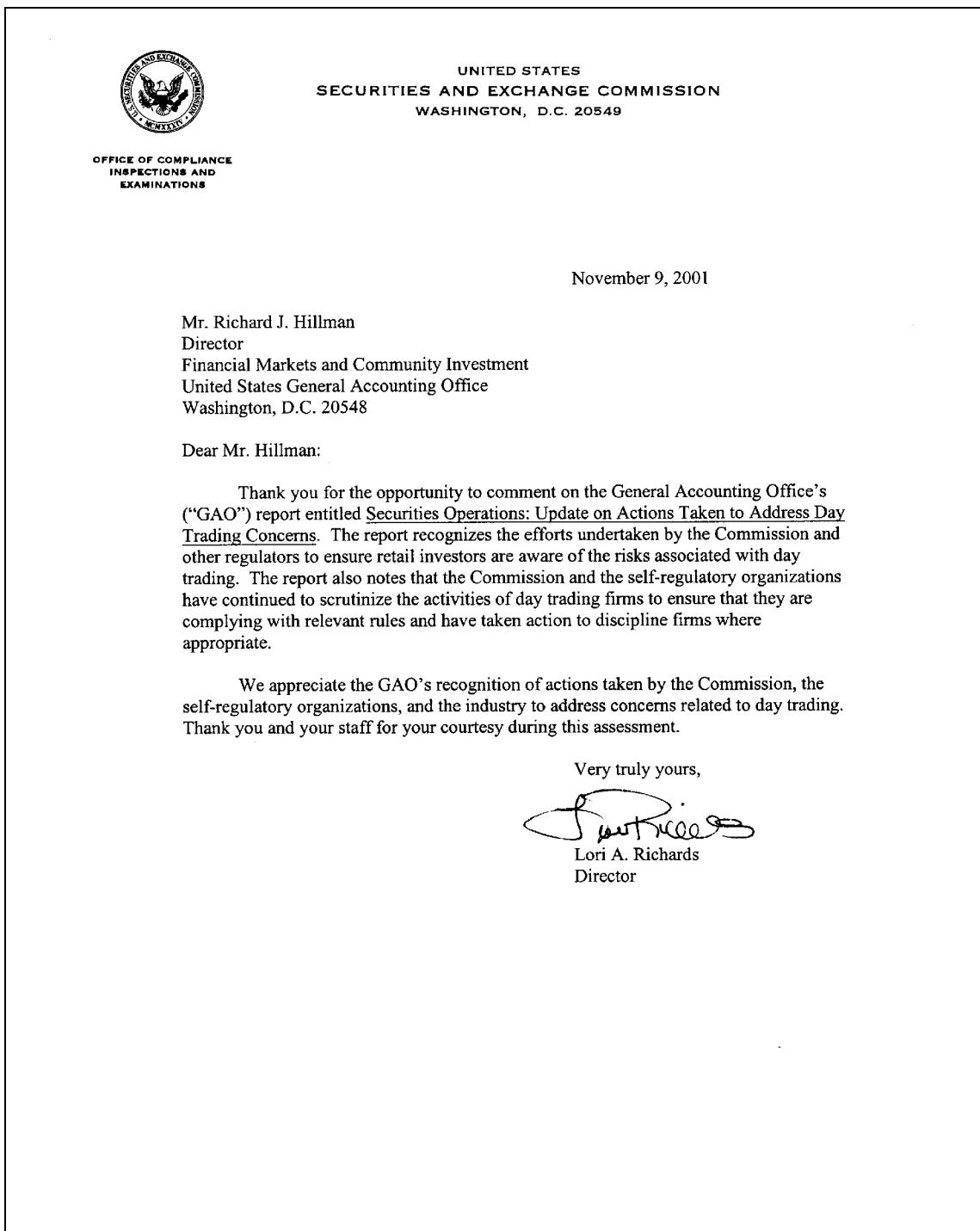
The Honorable Edolphus Towns  
Ranking Minority Member  
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Trade and Consumer Protection  
Committee on Energy and Commerce  
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The Honorable Edward J. Markey  
Ranking Minority Member  
Subcommittee on Telecommunications  
and the Internet  
Committee on Energy and Commerce  
House of Representatives

The Honorable John J. LaFalce  
Ranking Minority Member  
Committee on Financial Services  
House of Representatives

The Honorable Paul E. Kanjorski  
Ranking Minority Member  
Subcommittee on Capital Markets, Insurance and  
Government Sponsored Enterprises  
Committee on Financial Services  
House of Representatives

# Comments From the Securities and Exchange Commission



# Comments From the NASD Regulation, Inc.



NASD Regulation, Inc.  
1735 K Street, N.W.  
Washington, D.C. 20006  
202-728-8140  
202-728-8075 (fax)

**MARY L. SCHAPIRO**  
President

November 15, 2001

Mr. Richard J. Hillman  
Director, Financial Markets and Community Investment  
United States General Accounting Office  
Washington, DC 20548

Dear Mr. Hillman:

NASD is pleased to provide its comments on the GAO's draft report entitled *Securities Operations: Update on Actions Taken to Address Day Trading Concerns*.

With a membership that includes virtually every broker/dealer in the nation that does a securities business with the public, NASD is responsible for the regulatory oversight of the activities of more than 5,600 securities firms, their more than 80,000 branch offices, and the more than half-a-million registered securities professionals. We are committed to taking the appropriate action to continue to fulfill our mission of protecting investors and ensuring market integrity and we commend GAO on your work regarding day trading.

The subject of day trading has undergone extensive review beginning in 1999. Your report is insightful in demonstrating how day trader's operations have changed since then and what the regulators, including NASD, have done to address the concerns raised about day trading.

We have sent under separate cover our technical comments. Thank you again for the opportunity to comment on the draft report and we would be glad to answer any questions you may have regarding our comments.

Sincerely,

*Mary Schapiro*

Mary L. Schapiro

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